



Province of  
Saskatchewan

The Hon. J. Gary Lane, Q.C.  
Minister of Finance



# A DIALOGUE ON SASKATCHEWAN INCOME TAX REFORM



Honourable J. Gary Lane, Q.C.  
Minister of Finance  
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## Preface

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In 1985, the Government of Saskatchewan began the process of reforming Saskatchewan's tax system. We recognized that Saskatchewan's tax system had to reflect the concerns, expectations and vision of the people who built this province and who will shape its future.

Our early initiatives have contributed to the reopening of the issue of overhauling the national tax system. Tax reform has now attracted national attention. Ottawa's proposals to restructure both the income tax and the federal sales tax demonstrate that tax reform is not a fanciful vision, but a realistic goal.

The federal tax reform measures that are taking effect in 1988 have opened a window of opportunity to push ahead in reforming our provincial income tax system.

To ensure that the people of Saskatchewan would have a forum to express their concerns and suggestions about the future shape and direction of tax reform, we established the Saskatchewan Tax Reform Committee. Submissions received by the Committee contained a wide variety of reform proposals. But, all submissions shared one overriding message: the people of Saskatchewan want tax reform to continue.

This paper continues the process inaugurated by the Saskatchewan Tax Reform Committee. Accordingly, it sets out in some detail the issues, problems and options in restructuring our tax system. It also makes abundantly clear that tax reform is a complex issue which requires difficult decisions. And it seeks to develop a set of principles to guide us in making these decisions.

In addition, this paper provides an opportunity for all interested parties to consider and discuss the issues involved in reforming Saskatchewan's current tax system. Through a genuine dialogue, we can come to grips with the real issues and create a better provincial tax system.

The momentum for comprehensive tax reform is strong. To ensure that it does not falter and that a meaningful and comprehensive reform of Saskatchewan's tax system occurs, we welcome and invite public participation.

Each of us has a vision of what the future of Saskatchewan should be. Each of us also knows that the tax system is intimately related to that future. This paper is the next step in articulating that vision and shaping that future. This is the real challenge of tax reform.

March, 1988



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## **Introduction**

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In 1985, the Government of Saskatchewan called for a comprehensive reform of Canada's income tax system. It was our view that the tax system was no longer able to achieve its primary function of raising revenue in a fair and efficient manner.

The federal government's recent reform of the tax system confirmed the Province's position that there was a pressing need for governments to address the growing perception that the tax system was unfair, complicated and restricted job creation and economic growth.

### **Basic Principles**

Saskatchewan has identified a set of principles that a sound tax system should embody. We believe that such a system should be:

- consistent with widely accepted notions of equity, so that individuals and families see fairness in the system;
- consistent with overall social and economic policy objectives;
- simple enough that taxfilers do not generally require professional assistance to prepare their tax returns;
- a relatively stable source of government revenue; and,
- in harmony with the federal tax structure.

A challenging task facing governments is to reconcile these often conflicting principles in building a consensus on the direction of tax reform. Careful review of the relative merits of these principles is therefore required when judging the success of any reform initiative.

In 1985, Saskatchewan established support for the family as an essential element in undertaking personal income tax reform. We proposed that savings from tax reform should benefit the average family.

Support for the family continues to be an important factor directing Saskatchewan tax policy. Both in 1985 and in 1987, we restructured the Saskatchewan Tax Reduction to target greater tax savings to lower and middle income families. Future tax changes must advance this policy for fairness to be strengthened.

### **Tax Reform Elsewhere**

Over the past few years, major tax reform initiatives have been undertaken in many industrialized nations.

In the United States, a reform package was implemented in 1986 to improve the fairness, simplicity and neutrality of its tax system. The United States moved to a simpler tax code that encourages job creation and investment based on economic opportunities rather than on tax considerations.

The top personal marginal tax rate was reduced from 50 per cent to 28 per cent and an investor's ability to shelter income through losses and deductions was restricted. The corporate tax system was also significantly changed through a reduction of investment deductions and a decline in the corporate income tax rate from 46 per cent to 34 per cent.

Reform initiatives in other countries have been even more radical. New Zealand, for example, proposed the introduction of a flat rate tax levied on a comprehensive definition of income. This system was intended to eliminate distortions in economic behaviour while offering citizens the lowest possible tax rates. Other countries have introduced value-added taxes to augment personal income tax revenues.

The income tax proposals put forward by Ottawa had to take into account the United States tax reform. Our close economic ties made it necessary to avoid tax-induced distortions in business decisions. This is important in protecting the revenue base of the federal government and the provinces, especially in respect of large international corporations who are able to transfer income to the United States.

### **Saskatchewan Tax Reform**

This discussion paper examines the success of federal tax reform in meeting Saskatchewan's principles of a sound tax system. While the federal initiative achieved many of our objectives, some factors were not adequately addressed.

This paper presents, for discussion, certain concepts and alternatives that attempt to enhance fairness, support of the family and simplicity. It is our hope that the paper will generate debate by interested parties, leading to changes in the Saskatchewan tax system for 1989.

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### **Building a Sound Tax System**

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A tax system's primary function is the raising of revenue to support the social and economic programs of government. However, the design of a sound tax system is typically far more complicated than this simple revenue-raising function would imply. Difficulties arise because of the many fiscal, social and economic implications of the tax system. These include:

- fairness in the system;
- support for social policy;
- the advancement of economic policy;
- simplicity for both the taxfiler and the tax collector; and,
- harmony with other governments.

These considerations are often at odds with one another. For example, tax preferences can erode fairness since their benefits are often unevenly distributed. They can also limit the fiscal capacity of the tax system. Further, the introduction of a variety of tax expenditures can create a complex maze of considerations that the taxfiler must review in order to complete the tax form.



Government revenue sources must be adequate and reliable to ensure the ability to finance essential public services such as health care and education.

Stability of revenues does not necessarily imply an exact match with expenditures in all periods. Rather, the tax system should be cyclically sensitive so that revenue shortfalls incurred during economic downturns are offset by revenue gains during periods of economic strength.

Over the past few years, public attention has focussed on the fiscal problems facing all Canadian governments. Tax preferences can impede the revenue generating capacity of the federal and provincial tax systems. This is illustrated in the 1988 Budget Paper "Saskatchewan Tax Expenditures" which shows that hundreds of millions of provincial tax dollars are spent each year on a variety of social and economic objectives, including support for small business and for the family.

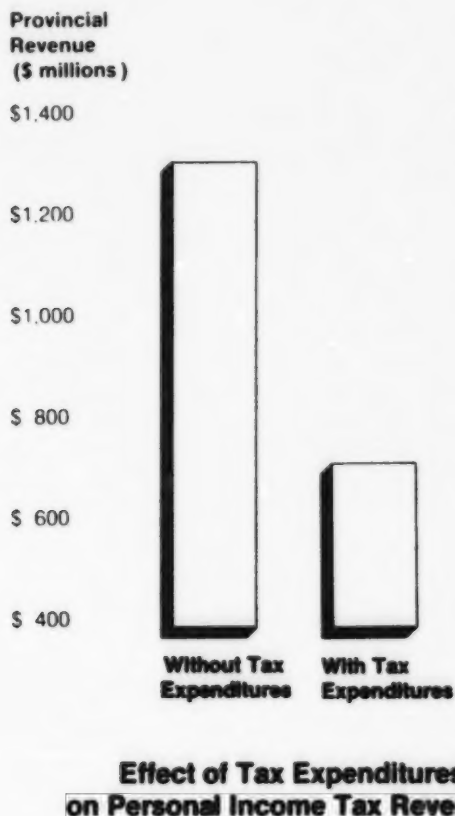


*Chart 1: Saskatchewan personal income tax revenues which would have been collected in 1987 without tax expenditures compared to revenues with tax expenditures in effect.*

Every government must ensure that there is the same degree of accountability for tax expenditures as for direct government expenditures.



## FAIRNESS

The Honourable Michael Wilson captured the feelings of many Canadians when he stated, "... the tax system should operate in a fair and equitable manner for all Canadians. This requires that all Canadians pay their share of tax and that the tax liability reflect an individual's ability to pay".

Fairness has been defined in many ways. In Canada, fairness is perceived as a progressive tax system which also treats individuals with similar incomes similarly. Any differences in treatment must be justifiable on social or economic grounds.

Fairness also means that individual or family needs must be recognized. Those below a certain income level should not pay income tax. Further, family circumstances and other characteristics such as age and disability must be recognized.

Traditionally, Saskatchewan's tax system has recognized both the level of income and family circumstance as critical factors in measuring a person's ability to pay tax.



## SOCIAL POLICY

Support for the family has been one of the cornerstones of the Saskatchewan tax system. Federal tax reform has altered both the level and distribution of that support.

Federal tax reform has made two key changes affecting support for the family:

- it converts personal exemptions into personal tax credits; and,
- it alters the relative value of personal tax expenditures, at the expense of many families.

Saskatchewan supports the conversion of personal exemptions to tax credits, as tax credits are more effective in targeting benefits toward lower and middle income individuals and families.

Saskatchewan is concerned, however, with the federal government's decision to restrict the value of the dependant tax credit to only \$65. The reduction in benefits from the dependant tax credit undermines the tax system's support for the family.

As part of our reform, we will examine ways of directing greater support to families.



## ECONOMIC POLICY

Traditionally, the tax system has been extensively used to accomplish a variety of economic objectives. Each measure added to the tax system was well intended and probably enjoyed some success at achieving its particular goal.

As some measures were added, a number of negative factors emerged, including continual escalations of tax rates, tax-induced distortions in investment decisions and levels of complexity that caused the average Canadian to distrust the fairness of the tax system.

### • Disincentives of High Tax Rates

The tax rate applied to each additional dollar of income, or what is called the marginal tax rate, has an important influence on people's economic decisions, particularly those concerning work effort and training.

For individuals paying top marginal rates of more than 50 per cent prior to tax reform, investment decisions were often driven more by tax considerations than by economic criteria. Federal tax reform addressed this issue. However, for average income individuals and families who continue to face marginal tax rates of 40 per cent, even after federal tax reform, tax rates can be an important factor when considering whether or not to work overtime.

Business decisions are also affected by the level of corporate tax rates. Lower rates provide general support for investment and job creation. Alternatively, higher tax rates encourage the transfer of income-earning activity to lower rate jurisdictions.

#### ● Investment Distortions

A number of tax preferences continue to distort personal investment in particular sectors. Deductions for accelerated depreciation on personal investments in Canadian films, multi-unit residential buildings and flow through shares were restricted under federal tax reform but will continue to play a role in future investment decisions.

Distortions in the corporate tax system occur where variations in tax rates, accelerated write-offs and measures such as the investment tax credit result in a bias towards certain types of industries. Preferences of this kind were significantly reduced under federal tax reform. However, advantages continue for certain capital intensive industries and for certain geographical regions outside of Saskatchewan.

Federal tax reform will lower personal tax rates and eliminate many economic distortions caused by the tax system. These actions will minimize tax preferences that have allowed some higher income Canadians to pay little or no tax. Lower personal tax rates will also encourage initiative and risk taking.

Federal tax reform also recognizes that some targeted tax incentives must remain to support Canada's capital requirements for growth and regional development while contributing to the country's ability to compete in world markets.

Saskatchewan will continue to target support for specific provincial objectives through the Saskatchewan Tax Incentives Program. This Program encourages the strengthening of Saskatchewan businesses and farms through equity participation by provincial residents. We will continue to ensure that this Program remains an effective and accountable means of promoting economic activity and job creation in Saskatchewan.



## SIMPLICITY

The complexity of the income tax system has created a massive demand for tax planning services. An entire industry depends on the tax code remaining overly complicated.

In the United States, it has been estimated that in excess of \$2 billion per year is spent by taxpayers on tax planning services. If the same pattern holds for Canada, roughly \$200 million is spent on similar services.

Complexity undermines public confidence in the fairness of the income tax system. Many Canadians suspect that complicated rules exist purely to benefit those able to afford expensive tax planning services.

If there was one principle of sound tax policy which was not achieved by federal tax reform, it would have to be simplicity. Federal tax reform only adds to the degree of complexity of the current tax system during the transition to the new system. It remains to be seen whether, over the long-term, inroads will be made in reducing complexity.



## HARMONY

Currently, Saskatchewan is one of nine provinces that have tax collection agreements with the federal government. These arrangements allow the use of the national tax system to collect and administer both federal and provincial income tax.

These agreements have meant that individuals and families have had to deal with only one income tax system. This is much simpler than in the United States where taxpayers are often required to file separate federal, state and municipal returns and are faced with multiple sets of tax rules.

Under the tax collection agreements, the provinces are dependent on a federally defined tax base. Therefore, if federal tax revenues fall, so do provincial tax revenues. Since federal income tax reform will reduce federal revenues, there will be an automatic reduction in Saskatchewan's personal income tax revenues of about \$30 million annually.

Federal tax reform offers the provinces an opportunity to address their concerns about the current federal-provincial arrangement. The system has been improved in recent years through formal consultation between the two levels of government when decisions to alter the tax base are being contemplated. However, we feel that a joint system can only be effectively maintained if there is also greater opportunity for the provinces to achieve their particular social and economic objectives.

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## Other Aspects of a Sound Tax System

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Saskatchewan also considers the following issues to be important in any reform package.

### Linkage to the Expenditure System



Saskatchewan has undertaken several major reviews of the government's expenditure system:

- departments have been subjected to a modified zero base budgeting process;
- the government has made long-term financial commitments in a number of key areas, such as health, education and agriculture; and,
- an improved and strengthened operational review process has been implemented.

Reform of the provincial expenditure system has been conducted in concert with tax reform. We have made a coordinated effort to achieve annual deficit reduction targets and we are heading toward a balanced budget.

Social and economic policy can be enacted through either the tax system or direct government expenditures. There is a clear need to improve the integration of taxation and expenditure programs to eliminate overlap and duplication while enhancing overall equity, neutrality and simplicity.

One example of a bewildering array of tax and expenditure programs is in the area of government support for the family. In 1985, in excess of \$375 million was spent by Ottawa and Saskatchewan on over 15 different family support programs ranging from child tax credits to day care subsidies and child care expense deductions.

Individually, these programs are laudable but when viewed as a package they raise questions about their cost-effectiveness in providing needed support to the family in an acceptable way.

## **The Underground Economy**



The underground economy exists in many sectors of the Canadian economy. It represents a source of income for many individuals. Unreported income is untaxed income and that means that some individuals are not paying their fair share of tax.

Estimates of the size of the underground economy are difficult to make. In the United States, the Internal Revenue Service estimated that, in 1986, it was over \$100 billion. In Canada, estimates are generally in the \$10 billion to \$20 billion range. Because this income is not reported, the federal and provincial governments forgo substantial tax revenues each year and, as a result, tax rates are higher than they otherwise would have to be.

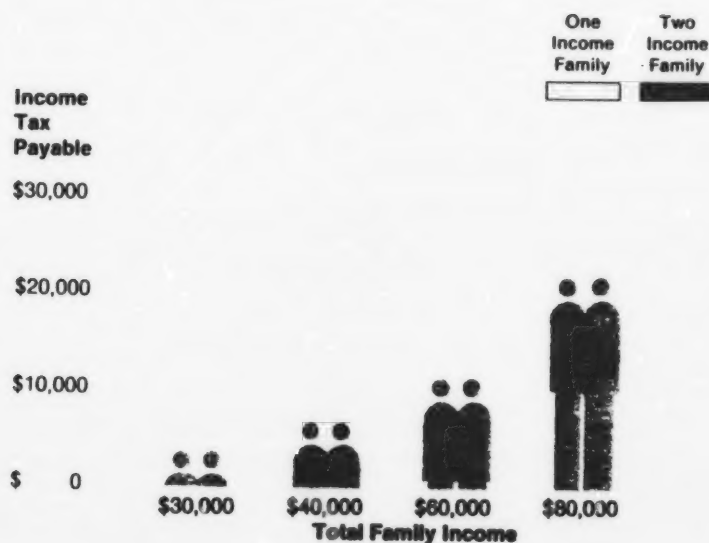
It is arguable whether individuals would report previously hidden income if the fairness of the tax system was improved. Nevertheless, reform of the system should serve to minimize the increase in the size of the underground economy in future years.

### **Family Unit Taxation**



In Canada, personal income tax is assessed on the basis of the income of the individual.

Consequently, the tax burden on the family differs depending upon the number of income earners. For example, a family of four with a total income of \$40,000 and only one earner will pay over 25 per cent more in income taxes than a similar family with two earners with incomes of \$20,000 each. This bias against single-earner families should be addressed as part of a review of the income tax.



## Effect of Family Income Splitting

*Chart 2: Federal and Saskatchewan income taxes paid by one-income families and two-income families, both with two children and equal total family incomes, at selected family income levels.*

Changes to the way in which we tax the family may have a significant impact upon the overall distribution of the tax burden and the perceived fairness of the income tax system. While initial steps have been taken to introduce the concept of family unit taxation, such as the federal child tax credit, we believe that further use of this approach should be investigated.

### Integration with the Corporate Income Tax



The removal of distortions and the lowering of tax rates are critical elements in encouraging economic activity and job creation. These elements are reflected in the corporate tax changes announced in the 1988 Saskatchewan Budget and in federal tax reform.

Personal income tax reform should move in the same direction, so that a coordinated approach is taken in the achievement of a sound tax system.

Other issues should also be addressed, including:

- a fair balance between the payment of tax by businesses versus individuals and families;
- neutrality between corporate and personal tax rates; and,
- the achievement of greater economic growth through enhanced risk taking.

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## Evolution of Saskatchewan's Tax System

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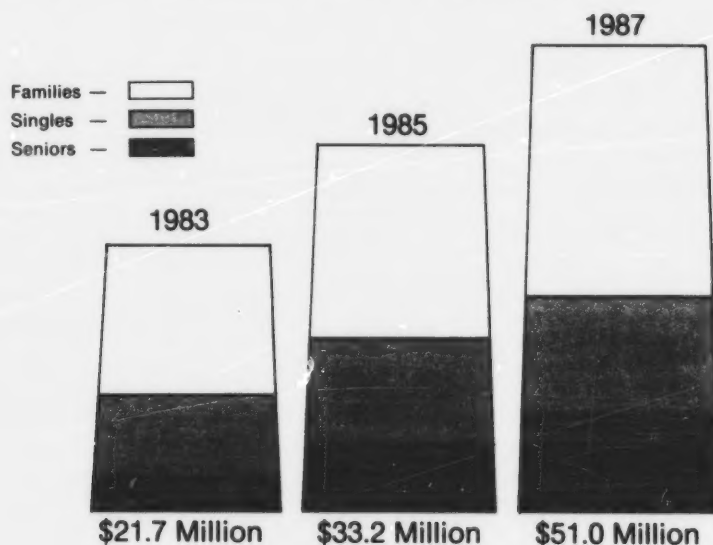
### Personal Income Tax

In the 1985 Budget, we expressed the concern that the average Canadian had lost confidence in the fairness of the national income tax system. Specifically, we concluded that the tax system exhibited a number of shortcomings and that major reform was necessary. Failure to eliminate or minimize these flaws would mean a continuing erosion of the tax system.

To restore confidence among taxpayers that all would pay their fair share, we introduced Canada's first reform initiative, the Saskatchewan Flat Tax.

A key aspect of Saskatchewan's approach has been our interest in balancing the competing interests of fairness, support for the family, economic policy, simplicity, revenue capacity and harmony. The introduction of the Flat Tax, while generating necessary revenue for health and education in a fair and uncomplicated manner, required federal cooperation and other adjustments to our overall tax system to achieve our goal of supporting the family.

The federal government's agreement to administer Canada's first Flat Tax represented a major concession, given the environment of competing federal and provincial interests. However, because of Ottawa's interest in maintaining the harmony and uniformity of the national tax system, the federal government requested that the Flat Tax be introduced as a temporary measure and that the tax base be Net Income, the broadest nationally recognized definition of income.



### Saskatchewan Tax Reduction Benefits

Chart 3: Distribution of income tax savings from the Saskatchewan Tax Reduction.

In the interest of maintaining harmony, Saskatchewan accepted the federal requirements. We have also continued to follow federal guidelines on what modifications can be made to improve the fairness of the Saskatchewan income tax system. Working within the federally administered system has required the Province to use less efficient methods of delivering its social and economic policies. For example, in 1987, the Province achieved greater support for the family by significantly altering the application of the Saskatchewan Tax Reduction. While very successful in assisting lower and middle income families, the Saskatchewan Tax Reduction did so at the expense of simplicity and ease of compliance.

Future provincial policies will continue to give a high priority to social justice within the tax system. If we can improve flexibility under the tax collection agreements, we will be able to do this with less administrative effort for all concerned.

Saskatchewan currently levies three tax rates:

- a basic tax levied on Basic Federal Tax;
- a flat tax levied on Net Income; and,
- a surtax levied on higher income.



## CURRENT TAX SYSTEM

The computation of tax is further complicated by the application of:

- a family tax reduction;
- a sales tax reduction; and,
- the Saskatchewan Tax Incentives Program.

These complications have resulted from restrictions imposed on the Province in the tax collection agreements. We have only been able to pursue social and economic policy objectives of interest to Saskatchewan residents through such complicated measures.

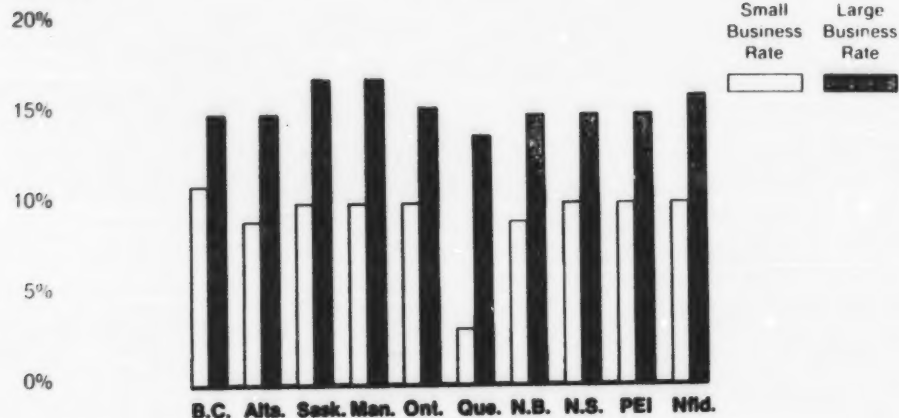
Ottawa has promised that provincial interests will be considered in the coming months as part of a comprehensive review of the tax collection agreements. It was the provinces' preference to complete this review during 1987. However, the breadth of the federal changes to the national tax system have made this impractical and the federal government has agreed to discuss provincial income tax concerns during 1988.

### Corporate Income Tax

Saskatchewan's corporate tax system has evolved into an inefficient means of collecting necessary government revenues. A number of serious flaws have emerged.

Corporate tax rates had become the highest in Canada. This has had both an economic and a fiscal impact on the Province.

**Corporation  
Income  
Tax Rate**



**1988 Provincial Corporation  
Income Tax Rates**

*Chart 4: Tax rates shown are provincial corporation income tax rates in effect for 1988 expressed as a percentage of Corporate Taxable Income.*

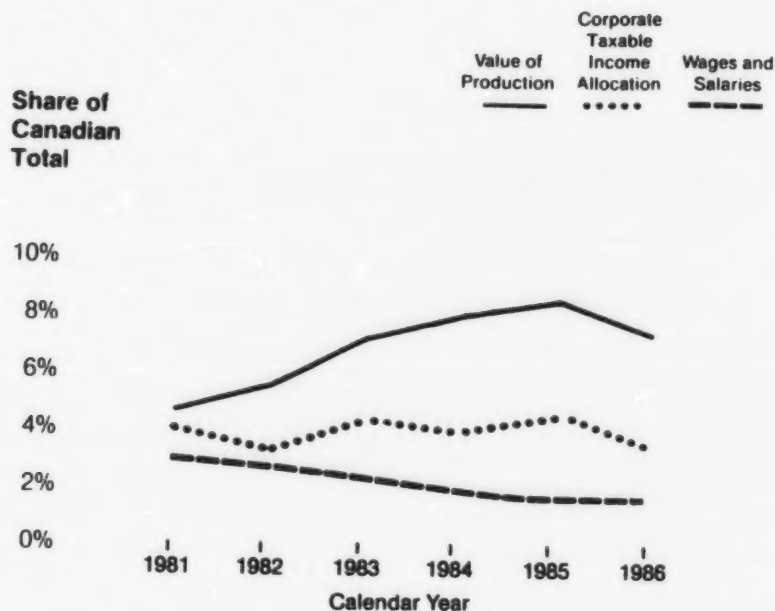
The economic impact stems from the fact that business activity generally locates where it can optimize its use of critical factors of production. When all other factors are equal, provincial levies such as income and capital taxes influence the location of a business's economic activity.

The fiscal impact is based upon the fact that an interprovincial corporation may attempt to minimize its tax burden by allocating income to jurisdictions with lower tax rates and allocating expenses to jurisdictions having higher tax rates. This practice has been used by interprovincial businesses which operate in both Saskatchewan and lower rate jurisdictions like Alberta. The result has been that these corporations maximize the income taxed in the lower rate jurisdiction at the expense of the Saskatchewan treasury.

An example of this "leakage" in provincial corporate tax revenue is in, but not limited to, the oil and gas sector. A divergence has become apparent between the level of economic activity in Saskatchewan's oil and gas sector, which has grown substantially throughout the 1980s, and our Province's share of corporate tax revenues pertaining to that activity, which has declined over the same period.

Divergence between economic activity and revenue capacity distorts the balance of corporate taxation in Saskatchewan. Large businesses which operate in other jurisdictions and have the capacity to alter their allocation of income and capital pay less than their relative share, while domestic industry makes up the shortfall.

Corporate tax revenues are an unstable source of government funding. Although the corporate income tax rate has risen from 11 per cent in the 1970s to 17 per cent today and a corporate capital tax system has been introduced, corporate tax revenues have not risen significantly as a revenue source. This is, in part, the result of the leakages caused by high tax rates.



### Saskatchewan Share of Canadian Oil and Gas Sector

Chart 5: Saskatchewan's share of oil and gas production, wages and salaries paid, and Corporate Taxable Income expressed as a percentage of the Canadian totals.

Saskatchewan's tax system contains a number of instances where preferential tax treatment is permitted, including a tax exemption provided to federal commercial Crown corporations which are taxed in other provinces. This creates competitive imbalances in certain industries and weakens the tax system's revenue generating capacity.

Federal corporate tax reform broadens the income base and lowers tax rates. This is intended to achieve greater neutrality in taxation and improve Canada's competitive position vis-a-vis the United States. Ottawa has requested that provincial corporate tax rates also be lowered in order to support this strategy.

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## Federal Tax Reform

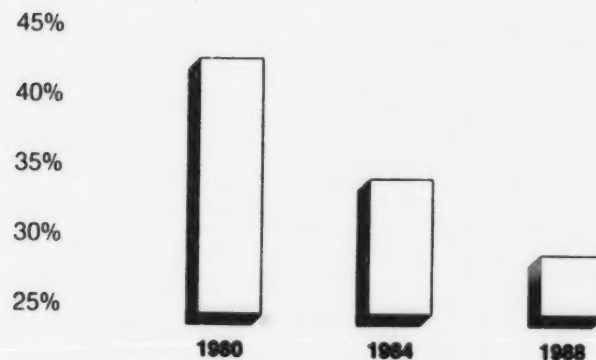
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There is much to support in the federal government's reform of the income tax system.

Federal reform provides a more neutral tax system in that income from employment, for example, is taxed more similarly to income earned from other sources, such as investment and business. This ensures that employees, who form the largest component of the taxpaying base, are no longer disadvantaged. Many deductions which reduced the effective tax rate on some income, such as the \$1,000 investment income deduction, have also been removed to improve fairness.

Federal reform also provides a general reduction in tax rates. Roughly eight out of every ten individuals will experience a reduction in income taxes. About 850,000 lower income Canadians will no longer have to pay personal income tax.

### Marginal Tax Rate



### Maximum Marginal Federal Tax Rates

*Chart 6: Tax rates shown are the maximum marginal federal income tax rates in effect, expressed as a percentage of Taxable Income.*

The replacement of personal exemptions with tax credits will increase the overall fairness of the tax system by better targeting benefits to lower and middle income Canadians.

Through federal reform, the corporate income tax system has become more neutral and rewards success with lower tax rates, while minimizing tax credits and deductions which often support inefficient investment activity. Canada's fiscal capacity is retained since corporations will not be encouraged to divert income-earning activity elsewhere.

The federal government has presented three options to replace the current federal sales tax including, their preferred option, a truly national sales tax that would involve the participation of both the federal government and provincial governments. If this option is introduced, the two orders of government would levy a single sales tax, thereby minimizing administration costs for governments and compliance expenses which burden the small business community and the general public.

We are carefully examining the federal proposal. It is our position that the Province will only enter into a national sales tax if there is clear and irrefutable proof that it will benefit the people of Saskatchewan and that it will in no way result in a shift of either economic activity or fiscal capacity from the Province.

To date, we have been active in working with the federal government and other provinces in reviewing certain aspects of a national sales tax. Specifically, we have opposed the taxation of food and increased taxation of local governments. We have been successful in receiving assurances from Ottawa that food will not be taxed and that local governments will not be adversely affected by a national sales tax. We will continue to examine other key aspects of the proposal, such as the tax status of Saskatchewan farmers.

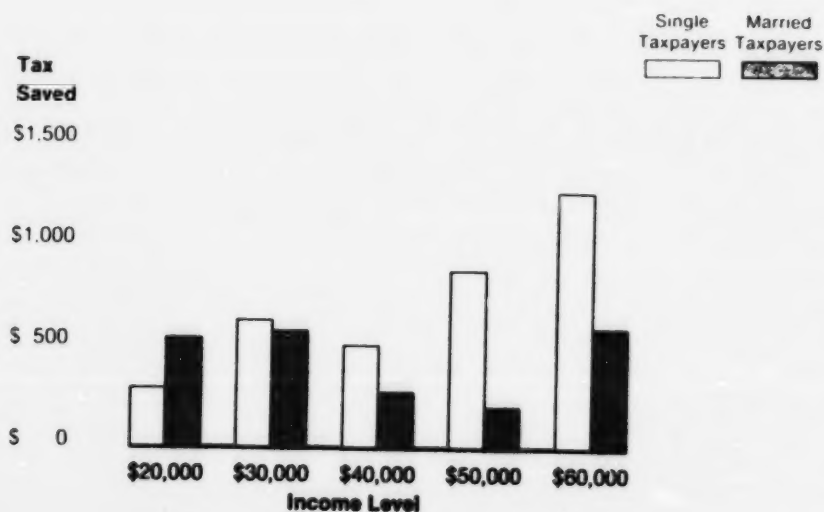
## Saskatchewan's Concerns with Federal Tax Reform

### Personal Income Tax

Last December, we established the Saskatchewan Tax Reform Committee and asked provincial residents to comment on federal tax reform and to provide direction to the Province on what actions are required in response to the federal changes.

We have received a number of submissions from a cross-section of Saskatchewan residents: from business and farm groups, labour, and from private individuals.

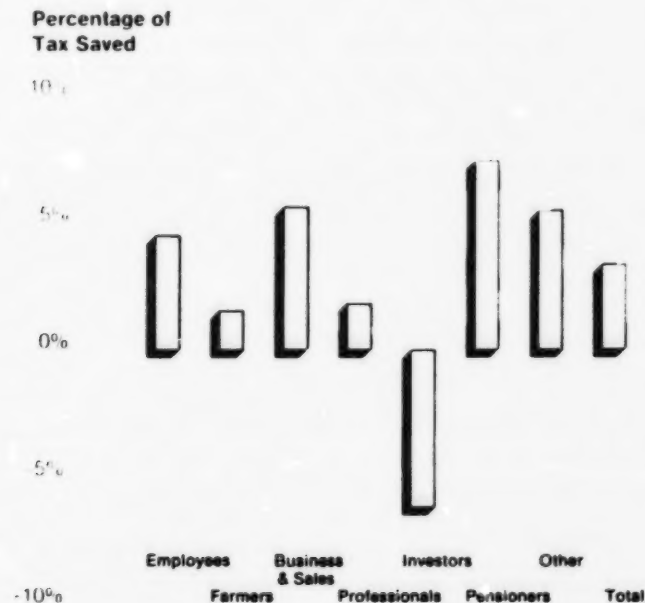
In general, there was support for the basic principles of federal tax reform. The goals of a simpler, fairer tax system struck a receptive chord. Specifically mentioned as positive elements of tax reform were the lowering of marginal tax rates, the conversion of deductions to tax credits and the restrictions on the use of certain investment incentives like MURBs and film shelters.



### Savings from Federal Tax Reform

Chart 7: Average benefits from federal tax reform for single taxpayers versus single-income families with two children, at selected income levels. Savings are shown in dollars.

There were also some common concerns raised in the submissions. These concerns focussed on the distribution of benefits of tax reform (especially as it pertained to middle income families), the extent to which tax rates have been lowered for higher income individuals and the lack of success at reducing the complexity in the tax system.



### Savings from Federal Tax Reform

Chart 8: Average benefits from federal tax reform by occupation group. Tax savings are shown as a percentage of pre-reform taxes.

- **Distribution of Tax Savings**

Federal tax reform provides greater tax savings to single taxfilers than to families. There is also a wide divergence of tax savings throughout the income ranges, with many middle income families appearing to be relatively disadvantaged.

Saskatchewan employees and pensioners are major beneficiaries from federal tax reform since lower tax rates provide a positive trade-off for the loss of certain deductions like the employment expense and investment income deductions. Farmers can expect a decline in taxes subject to clarification from the federal government of their 1989 tax calculation.

- **Lower Tax Rates**

Federal reform placed a great deal of importance on the lowering of marginal tax rates to encourage investment and economic growth. However, tax rate reductions provide larger tax savings to many higher income earners. While agreeing with the general principle of lower tax rates, we are concerned with the distribution of benefits.

### • Family Unit Taxation

A distinct feature of the Canadian tax system, compared to other tax systems, is the definition of the taxpayer. In Canada, the individual is subject to tax, whereas other tax systems are based on taxing the family.

One advantage of family unit taxation is the neutrality it provides. Such a system levies a similar tax load on a single-income family as it does on a two-income family earning a comparable level of income.

This paper will present an alternative which encompasses the integration of a family's tax liability to promote greater neutrality.

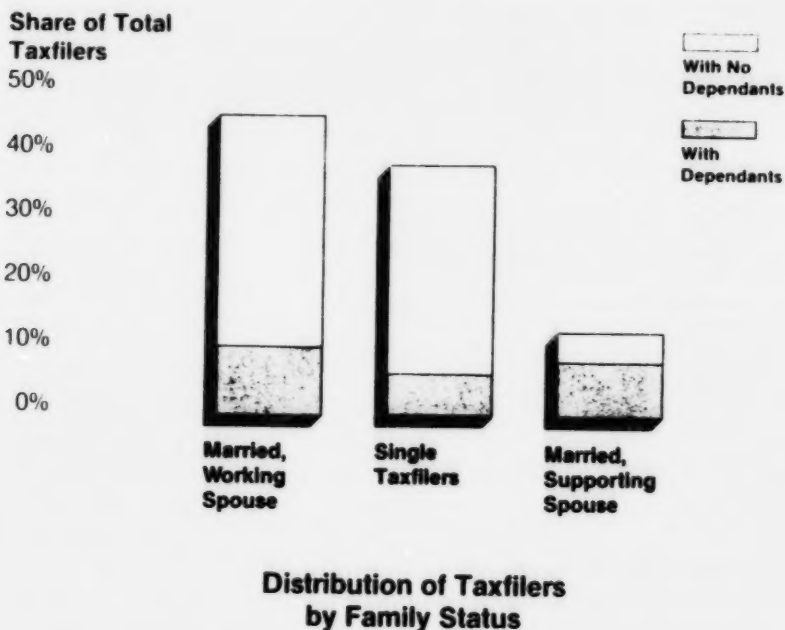


Chart 9: Percentage of the total number of Saskatchewan taxfilers represented by each family status.

### • Complexity of the Tax System

Federal tax reform does little to simplify the current tax rules. The conversion of deductions and exemptions to tax credits and changes to other tax preferences will create additional complexities for taxfilers during the transition to the new system.

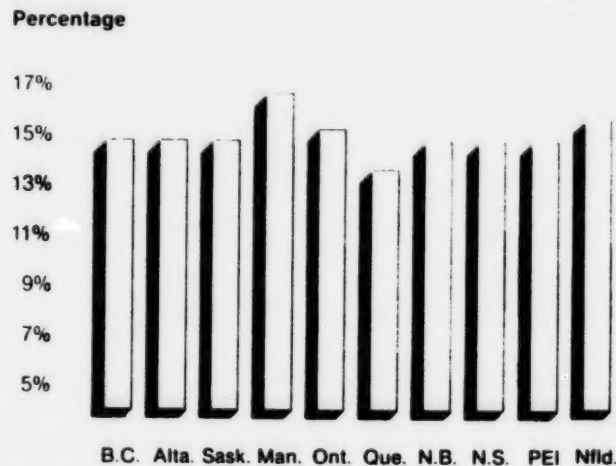
Because of the Province's limited flexibility in promoting its social and economic policies through the income tax system, calculation of provincial income tax can be complicated. Increased flexibility under the tax collection agreements would permit the Province to simplify its tax calculation while allowing the achievement of Saskatchewan social and economic objectives.

### Corporate Tax

The 1988 Saskatchewan Budget introduces a corporate tax package that creates a more neutral, competitive tax environment for Saskatchewan businesses. It encompasses the following measures:

- effective for 1989, a lowering of the general corporate income tax rate to a competitive level with other provincial jurisdictions;

- effective Budget night, an extension of the two-year corporate tax holiday for new small businesses to March 31, 1990;
- effective July 1, 1988, the inclusion of federal commercial Crown corporations under the Corporation Capital Tax;
- effective for 1989, the repeal of the Small Business Manufacturing and Processing Tax Reduction; and,
- effective July 1, 1988, the introduction of a surcharge on resource companies which are subject to the Corporation Capital Tax.



### 1989 Provincial Corporation Income Tax Rates

*Chart 10: Tax rates shown are 1989 general provincial corporation income tax rates expressed as a percentage of Corporate Taxable Income.*

These measures present a comprehensive approach to the achievement of fairness, simplicity, social and economic policy, revenue capacity and harmony in the taxation of the Saskatchewan business community.

- **Fairness and simplicity** are achieved through the elimination of tax preferences which distort both economic behaviour and the allocation of tax revenues by large interprovincial companies. Domestic industry, which currently pays a proportionately higher tax load, will be better off under these measures.
- **Social policy** is furthered by the increase in corporate tax revenue, which can be used to finance government priorities such as health and education.
- **Economic policy** is furthered by a leveling of the playing field, a lowering of the general corporate income tax rate and the continuation of the small business tax holiday.

- **Revenue capacity** is improved through base-broadening initiatives and through the introduction of the corporate capital tax surcharge. Incremental revenue is also expected from the economic benefits of lowering the corporate income tax rate to a competitive level.
- **Harmony** with federal tax reform is achieved through a lowering of the corporate income tax rate. This will reinforce the federal tax rate reductions creating a positive environment for economic growth and job creation.

#### **Saskatchewan Small Business**

The local business tax currently generates \$40 million annually of which almost 40 per cent is paid by the Regina business community. We propose to address the concerns of small businesses throughout the province regarding this levy. It is only fair that local governments which impose the business tax assist in reducing the burden on small business.

In 1989, we will set aside up to \$10 million of the revenues generated from the corporate tax changes to assist in this effort, subject to the following:

- local governments will be encouraged to match provincial assistance dollar-for-dollar;
- special recognition will be provided to communities which have already reduced or eliminated their business tax;
- local governments must not raise residential property taxes to provide funds for their matching assistance;
- transfer payments will not be increased to offset any costs incurred by local governments; and,
- benefits will be targeted to small businesses.

This approach challenges local governments to reduce their expenditures to assist their small business communities in reducing the business tax.

Assuming local governments choose to participate, this can mean a 50 per cent reduction in the business tax for small businesses.

Discussions will be undertaken with local government representatives to determine the most appropriate mechanism to implement this proposal.

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#### **Opportunities for 1989**

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This is a year of transition for Saskatchewan's personal and corporate tax systems. The effects of federal tax reform will occur in 1988. We are proposing to alter corporate tax policies as the first step in our reform process.

The corporate tax changes will result in a more neutral tax burden among competing corporations.

Saskatchewan industry will benefit from a lower corporate income tax rate, the extension of the two-year corporate income tax holiday and our commitment to lower the business tax.

Large resource corporations and federal Crown corporations will finance the tax savings to local industry through the expansion of the Corporation Capital Tax.

Saskatchewan's personal income tax system requires change to make it fairer and simpler. Since the tax collection agreements are currently under review, it is our goal to introduce meaningful reform for the 1989 tax year. This could involve a significant departure from the traditional federal-provincial tax collection relationship.

The following four alternatives are presented for public discussion:

1. **Saskatchewan Progressive Flat Tax Structure Alternative**

Progressivity is usually associated with the use of a tax rate structure in which marginal rates increase with income. However, this is not always the case. A marginal tax rate structure does not guarantee progressivity. This was the case in the pre-reform federal tax system, where some upper income taxpayers had opportunities to reduce effective tax rates to levels lower than those faced by middle income families.

It is possible to design a progressive tax system with a single tax rate. A progressive flat tax can provide each taxpayer with a basic allowance. Income above that amount would be taxed at one rate.

The critical elements in a progressive flat tax are a comprehensive income base and tax credit support for the family. Saskatchewan presents, for discussion, a progressive flat tax structure.

The following tax rates would apply:

| <b>Taxable Income</b> | <b>Saskatchewan Tax Rate</b> |
|-----------------------|------------------------------|
| Up to \$50,000        | 15%                          |
| \$50,000 and over     | 15% plus 5% surtax           |

The above rates would be accompanied by the following credits:

| <b>Proposed Tax Credits *</b>    | <b>Value of Tax Credits</b> |
|----------------------------------|-----------------------------|
| Basic                            | \$ 1,350                    |
| Married/Married Equivalent       | 1,350                       |
| Dependants under 18              | 150                         |
| Dependants over 18 and infirm    | 125                         |
| Age 65 and over                  | 275                         |
| Disabled                         | 275                         |
| Pension Income (max \$85 credit) | 8.5%                        |
| Tuition Fees                     | 8.5%                        |
| Education Allowances             | \$ 5 per month              |
| Charitable Donations             | 8.5% **                     |
| Medical Expenses                 | 8.5% **                     |
| UI/CPP Contributions             | 8.5%                        |

\* Credits are calculated as 50% of 1988 federal tax credits, plus additional credit support for families.

\*\* Charitable donations in excess of \$250 per year would be permitted a 14.5% tax credit; medical expenses in excess of 3% of net income would be eligible for the tax credit.

**Highlights**

**Saskatchewan Progressive Flat Tax Structure**

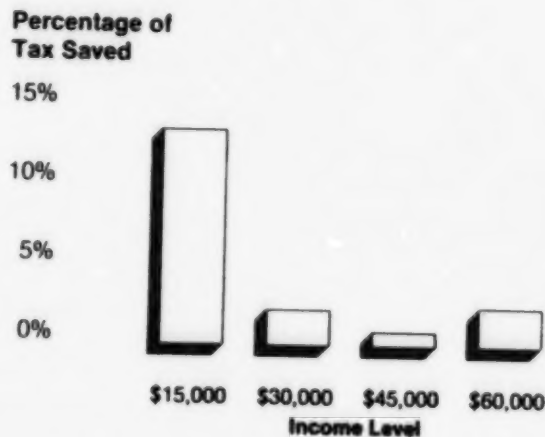
- **Fairness improved:** 48,000 lower income individuals and families no longer pay provincial income tax.
- **Simplicity improved:** over 95% of all taxfilers subject to a single rate of tax.
- **Support for the family:** significant tax reductions for lower and middle income families through enhanced family tax credits.
- **Redistribution of tax burden:** individuals with annual incomes under \$9,200 and families with annual incomes under \$20,500 would pay no provincial income tax; surtax of 5% on incomes over \$50,000.
- **Harmony maintained:** provincial support for federal tax credits.
- **Lower tax rates:** top combined marginal tax rate lowered from 56.3% to 49.9%.
- **Revenue neutral.**

The major advantages of this structure are that:

- fairness is enhanced as demonstrated by a decline of 48,000 in the number of lower income taxpayers;
- neutrality is promoted as tax savings from income splitting among family members are substantially reduced;
- the family structure is a primary consideration in measuring ability to pay;
- a single tax rate is applied to almost all taxfilers, permitting a simpler tax calculation;
- lower marginal tax rates encourage initiative and risk taking, leading to economic gains;
- harmony with the federal system continues as the federally defined income base and support for federal tax credits are fundamental to the operation of the flat tax; and,
- integration with the provincial corporate income tax system is achieved since both the general personal and corporate tax rates would be 15 per cent.

The disadvantages are that:

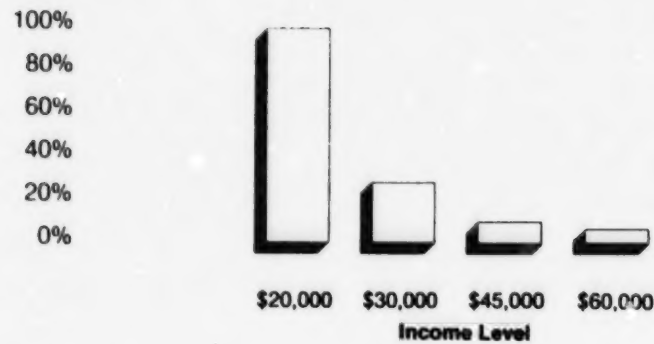
- the introduction of Canada's first progressive flat tax would be a significant change to the traditional approach of provincial income taxation; and,
- savings from federal tax reform are reduced for single taxpayers.



#### Percentage Savings for Single Taxpayers, Progressive Flat Tax Structure

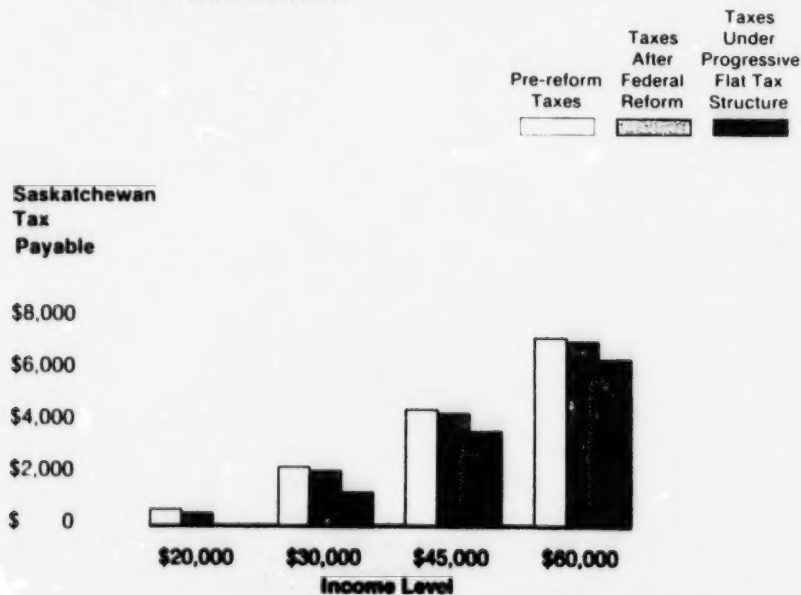
Chart 11: Benefits from Saskatchewan Progressive Flat Tax Structure Alternative for single taxpayers at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.

### Percentage of Tax Saved



### Percentage Savings for Married Taxpayers, Progressive Flat Tax Structure

Chart 12: Benefits from Saskatchewan Progressive Flat Tax Structure Alternative for single-income families, with two children, at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.



### Effect of Progressive Flat Tax Structure for Married Taxpayers

Chart 13: Saskatchewan income taxes paid by single-income families, with two children, at selected income levels before tax reform, after federal tax reform and under the Saskatchewan Progressive Flat Tax Structure Alternative.

## 2. Saskatchewan Marginal Tax Structure Alternative

Federal tax reform reaffirmed the national tax system's reliance on a marginal tax rate structure. This has permitted a progressive provincial income tax system.

Saskatchewan currently enhances fairness and progressivity in our tax system through the Saskatchewan Tax Reduction and the surtax. However, these important measures contribute to the complexity of the tax system.

Further action will be required to tailor the impact of federal tax reform benefits to Saskatchewan's principles of a sound tax system. It appears that the lowering of federal tax rates provides a disproportionate benefit to those earning larger incomes. There also appears to be relatively low tax savings to the family.

Saskatchewan is concerned with the distributional implications of the new federal tax structure. One option would be to establish our own marginal tax rate structure. This alternative would ensure that a fairer distribution of tax is borne by higher income individuals and would permit greater support to be directed toward the family.

The following tax rates would apply:

| Taxable Income      | Saskatchewan Tax Rate |
|---------------------|-----------------------|
| Up to \$20,000      | 10%                   |
| \$20,000 - \$45,000 | 15%                   |
| Over \$45,000       | 20%                   |

The above rates would be accompanied by the following credits:

| Proposed Tax Credits*             | Value of Tax Credits |
|-----------------------------------|----------------------|
| Basic                             | \$ 612               |
| Married/Equivalent to Married     | 510                  |
| Dependants under 18               | 239                  |
| Dependants over 18 and infirm     | 150                  |
| Age 65 and over                   | 330                  |
| Disabled                          | 330                  |
| Pension Income (max \$102 credit) | 10%                  |
| Tuition Fees                      | 10%                  |
| Education Allowance               | \$6 per month        |
| Charitable Donations              | 10%**                |
| Medical Expenses                  | 10%**                |
| UI/CPP Contributions              | 10%                  |

\* Credits are calculated as 60% of 1988 federal tax credits, plus additional credit support of \$200 for dependants under 18.

\*\* Charitable donations in excess of \$250 would be permitted a 17% tax credit; medical expenses in excess of 3% of net income would be eligible for the tax credit.

### Highlights Saskatchewan Marginal Tax Structure

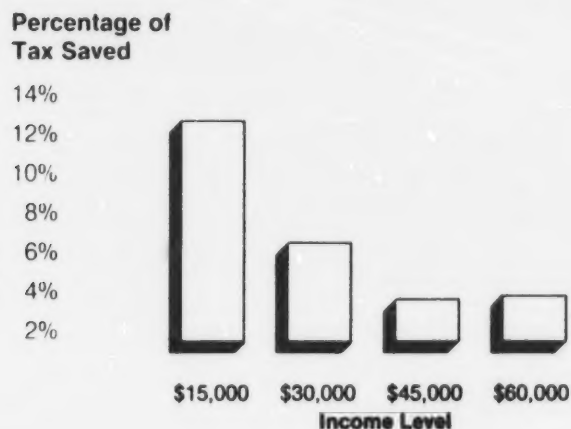
- **Support for the family:** substantial tax reductions for lower and middle income families.
- **Redistribution of Tax Burden:** family tax savings supported by higher income earners and single taxpayers.
- **Lower tax rates:** top combined marginal tax rate reduced from 56.3% to 49.9%.
- **Revenue neutral.**
- **Harmony maintained:** consistent with federal tax structure; enhanced support for federal tax credits.

The major advantages of this structure are that:

- a marginal tax rate structure, by definition, maintains the traditional Canadian approach to progressive taxation;
- the expansion in support for federal tax credits, from 50 per cent in 1988 to 60 per cent in 1989, and an additional provincial credit of \$200 for each dependant child, provides greater support for the family; and,
- the structure is simpler than the current system's reliance on the flat tax, surtax and tax reductions for fairness.

The disadvantages are that:

- harmony with the federal tax system is diminished through the creation of unique provincial tax brackets and rates;
- an element of complexity is introduced through a separate marginal tax rate structure; and,
- an increase of 10,000 in the number of individuals paying Saskatchewan income tax.



**Percentage Savings for  
Single Taxpayers; Marginal Tax Structure**

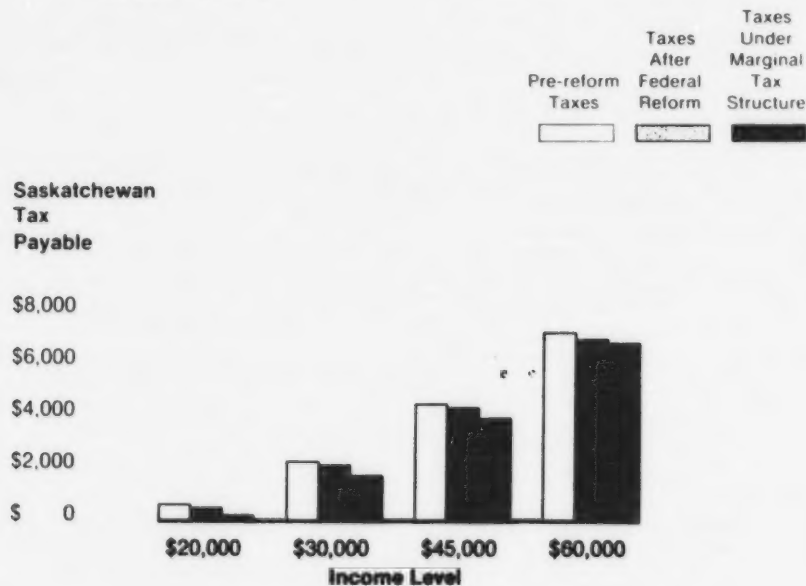
*Chart 14: Benefits from Saskatchewan Marginal Tax Structure Alternative for single taxpayers at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.*

### Percentage of Tax Saved



### Percentage Savings for Married Taxpayers, Marginal Tax Structure

Chart 15: Benefits from Saskatchewan Marginal Tax Structure Alternative for single-income families, with two children, at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.



### Effect of Marginal Tax Structure for Married Taxpayers

Chart 16: Saskatchewan income taxes paid by single-income families, with two children, at selected income levels before tax reform, after federal tax reform and under the Saskatchewan Marginal Tax Structure Alternative.

### 3. Saskatchewan Pure Flat Tax Structure Alternative

The simplest and least distortionary of all tax systems is the pure flat tax – one tax rate levied on as comprehensive a definition of income as possible. No deductions from tax would be permitted, removing the current system's support for the achievement of social and economic policies. For example, no support would be provided through the tax system for the family and for such items as medical expenses, charitable donations and dividend tax credits.

The pure flat tax permits as low a rate as possible while achieving the government's revenue requirements. Saskatchewan could introduce a pure flat tax rate of 7.5 per cent levied on Taxable Income and generate the same revenue as under the present system.

Although the pure flat tax has received consideration from some governments, most notably the Government of New Zealand, it has not yet been widely accepted.

#### Highlights Saskatchewan Pure Flat Tax Structure

- **Simple design:** all taxpayers pay the same tax rate with no deductions from tax.
- **Low tax rates:** top combined marginal tax rate reduced from 56.3% to 37.4%.
- **No Support for the family:** personal and other credits removed.
- **Redistribution of tax burden:** all income earned is taxed; 170,000 lower income earners added to the tax rolls; 170,000 middle and higher income earners will pay lower taxes.
- **Lack of harmony:** a significant divergence from the federal tax system.
- **No progressivity:** higher income earners experience a greater relative tax saving than lower income earners.
- **Revenue neutral.**

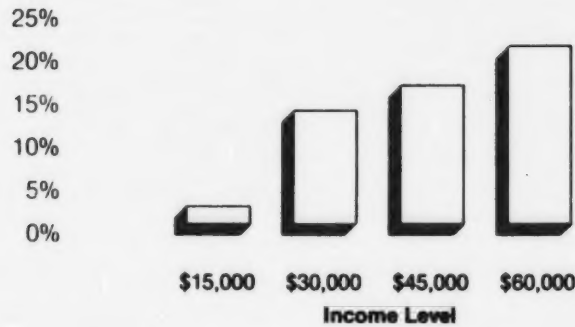
The major advantages of this structure are that:

- lower tax rates encourage risk taking and initiative through higher after-tax rewards;
- a tax system without preferences ensures that some taxpayers are not able to artificially reduce taxes;
- a single tax rate ensures fairness in taxing the family unit, since splitting income among family members provides no advantage; and,
- a single tax rate system is simpler, since no credits would be permitted in computing tax.

The disadvantages are that:

- the pure flat tax does not acknowledge the principle of progressivity in taxation;
- it does not recognize the family circumstances of the taxpayer, a major component of the Saskatchewan vision of fairness; and,
- harmony with the federal tax system is substantially diminished, since the principle of progressivity is not maintained and support for federal credits is non-existent.

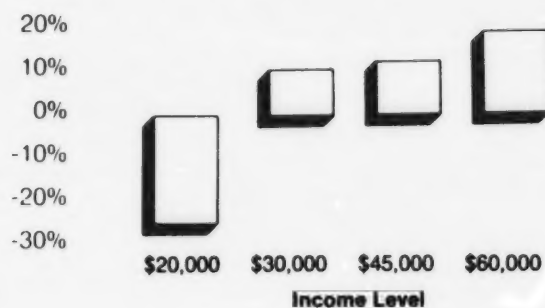
**Percentage of  
Tax Saved**



**Percentage Savings for  
Single Taxpayers, Pure Flat Tax Structure**

*Chart 17: Benefits from Saskatchewan Pure Flat Tax Structure Alternative for single taxpayers at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.*

**Percentage of  
Tax Saved**



**Percentage Savings for  
Married Taxpayers, Pure Flat Tax Structure**

*Chart 18: Benefits from Saskatchewan Pure Flat Tax Structure Alternative for single-income families, with two children, at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.*

#### 4. Saskatchewan Independent Tax System Alternative

Currently, Quebec is the only province in Canada that administers its own personal income tax system. By introducing its own income tax system in 1954, Quebec established the principle that each province can adopt its own perception of fairness through both provincial tax rates and the structure of the tax.

In 1985, Ontario studied the option of leaving the tax collection agreements, but concluded that although greater flexibility to achieve objectives specific to Ontario could result, these objectives could also be achieved as a member of the national tax system.

Serious consideration by Saskatchewan to create its own personal income tax system would require a detailed review of advantages and disadvantages. Increased flexibility would be an advantage to the Province in promoting Saskatchewan objectives, including job creation, economic growth and investment. In addition, a Saskatchewan income tax system could also lead to greater provincial influence on federal tax policies.

Many disadvantages would result from the introduction of a Saskatchewan income tax system. Cost of compliance and administration for a Saskatchewan system would be high. Estimates suggest that such a system would cost approximately \$30 million annually to administer, after the initial capital cost. Compliance costs for individuals and employers could be as high as \$50 million annually.

The decision to introduce a Saskatchewan income tax system would be a major step for the Province. It would require the development of a strong consensus that other less radical solutions to the present system's problems are unworkable.

#### Comparison of Tax Structure Alternatives

| Proposed Tax Rates | Progressive Flat Tax Structure                                                   | Marginal Tax Structure                                                | Pure Flat Tax Structure     |
|--------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------------------|-----------------------------|
|                    | 15% on all Taxable Income;<br>5% Surtax on Taxable Income in excess of \$50,000. | 10% (\$0-\$20,000)<br>15% (\$20,000-\$45,000)<br>20% (Over \$45,000). | 7.5% on all Taxable Income. |

| Proposed Tax Credits          | Progressive Flat Tax Structure | Marginal Tax Structure | Pure Flat Tax Structure |
|-------------------------------|--------------------------------|------------------------|-------------------------|
| Basic                         | \$ 1,350                       | \$ 612                 | \$ 0                    |
| Married/Equivalent-to-Married | 1,350                          | 510                    | 0                       |
| Dependants under 18           | 150                            | 239                    | 0                       |
| Dependants over 18 and infirm | 125                            | 150                    | 0                       |
| Age 65 and over               | 275                            | 330                    | 0                       |
| Disabled                      | 275                            | 330                    | 0                       |
| Pension Income                | 8.5%                           | 10%                    | 0                       |
| Tuition Fees                  | 8.5%                           | 10%                    | 0                       |
| Education Allowances          | \$ 5/month                     | \$ 6/month             | 0                       |
| Charitable Donations          | 8.5% *                         | 10% **                 | 0                       |
| Medical Expenses              | 8.5% *                         | 10% *                  | 0                       |
| UI/CPP Contributions          | 8.5%                           | 10%                    | 0                       |

\* Charitable donations in excess of \$250 per year would be permitted a 14.5% tax credit; medical expenses in excess of 3% of Net Income would be eligible for the tax credit.

\*\* Charitable donations in excess of \$250 per year would be permitted a 17% tax credit.

## **Reform Alternatives**

This paper has presented, for discussion, four alternative approaches to Saskatchewan tax reform. Each of the alternatives attempts to satisfy our principles in a different manner. Choices have to be made between competing principles. The attainment of one principle often erodes the tax system's ability to address other principles.

The alternative of creating a **Saskatchewan independent tax system** (Alternative 4) would be a major step for Saskatchewan. While providing a broader avenue for provincial action in dealing with our own interests, a separate income tax system would raise a number of contentious issues.

The Government of Saskatchewan considers withdrawal from the national tax system as an option of last resort in the achievement of a sound tax system. It would represent an admission that provincial objectives in income taxation cannot be achieved within the federal-provincial tax collection agreements.

There are a number of trade-offs in considering a **pure flat tax structure** (Alternative 3). A single tax rate would generate positive economic benefits for the province through the encouragement of individual initiative and risk taking. It would also provide taxpayers with a simpler, more neutral tax system by not allowing deductions from tax.

A pure flat tax system would also raise certain concerns. It would substantially increase the tax burden of lower income individuals and families and would provide significant tax reductions for higher income taxpayers. A flat tax would also eliminate our ability to acknowledge the family circumstance of the taxpayer when computing tax.

These concerns could be offset by transferring our commitment of support for lower and middle income individuals and families to direct expenditure initiatives. This was proposed by New Zealand through the introduction of a guaranteed minimum family income program.

The remaining two alternatives for provincial reform are constructed in a manner that places greater emphasis on the achievement of fairness through support for the family, simplicity and lower marginal tax rates.

Each alternative achieves these objectives; however, they do so in different ways.

A **marginal tax structure** (Alternative 2) presents an approach more consistent with the current federal-provincial tax system. Progressive tax rates are used to ensure fairness. Support for federal tax credits continues the tax system's support for the family.

A **progressive flat tax structure** (Alternative 1) represents a departure from the federal tax system as a single tax rate is applied to every taxpayer, with a surcharge levied on higher incomes. Both progressivity and support for the family are enhanced by permitting substantial family tax credits established by the Province. Provincial support for other federal tax credits would continue at current levels.

A major difference between these two alternatives is the way each treats the two-income family. This is an important consideration given the changing characteristics of the family.

Under a **marginal tax structure**, a higher income spouse could benefit from splitting income with a lower income spouse. This would add to the federal tax system's bias in favour of two-income families which results from the difference between the federal spousal tax credit of \$850 and the federal basic personal tax credit of \$1,020.

A **progressive flat tax structure** would virtually eliminate the advantages of income splitting and the preferential treatment given to the two-income family by applying the same rate of tax to all income and by providing a similar tax credit on behalf of the spouse, regardless of whether that person works inside or outside of the home.

### **Distributional Impact**

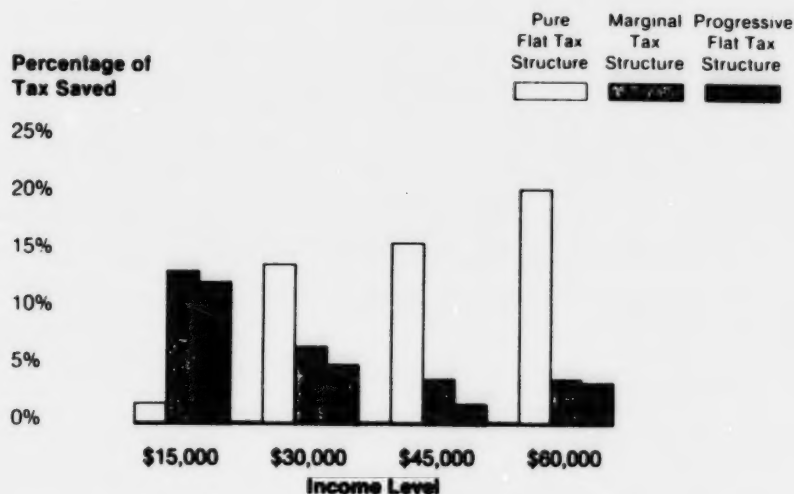
Each alternative would affect individuals and families differently.

A **pure flat tax structure** would significantly alter the distribution of provincial income tax. Families and lower income individuals would pay a greater share of the tax burden. For example, a one-income family with two children and earning \$20,000 would see an increase of almost 140 per cent in their income tax. In contrast, an individual earning \$60,000 would receive a decrease of over 40 per cent in taxes.

A **marginal tax structure** and a **progressive flat tax structure** would provide the family with significant tax reductions.

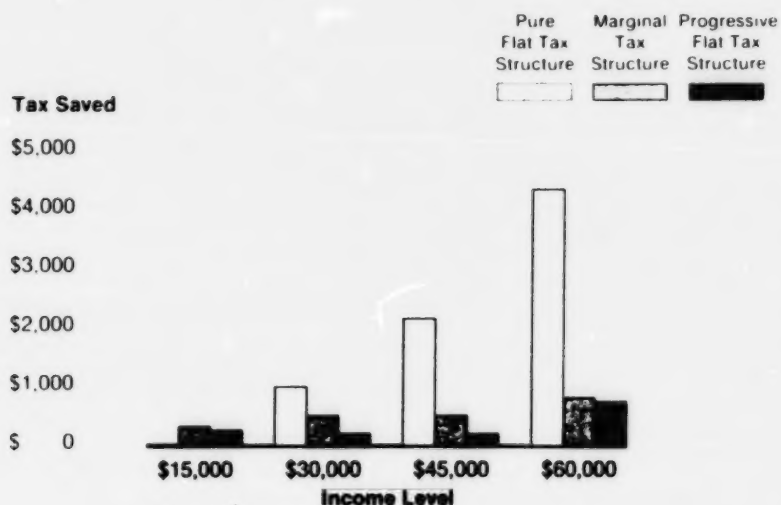
As illustrated in the 1988 Budget Paper "Interprovincial Comparison of Taxes and Charges", a single-income family earning \$20,000 currently pays \$633 in provincial income tax. Under the **marginal tax structure** alternative, that family would experience a decline of approximately 50 per cent in provincial income tax. The **progressive flat tax structure** provides even greater support to this same family, completely eliminating their provincial income tax.

Families earning higher levels of income will also experience modest declines in income tax. However, the reductions are dramatically different between the **marginal tax structure** and the **progressive flat tax structure**. The tax reduction for a family earning \$60,000 under the former will be about one per cent of provincial tax payable, while the latter will permit a slightly higher tax saving to this family, equal to almost ten per cent of current provincial taxes payable.



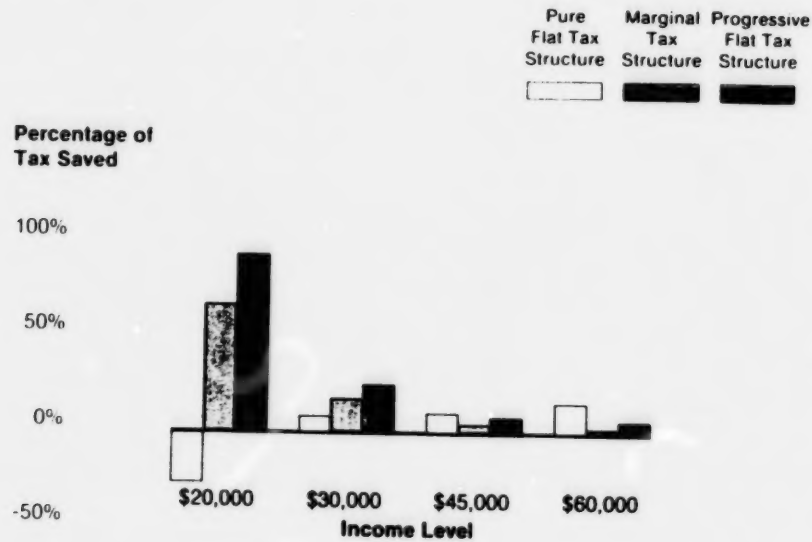
### Percentage Savings for Single Taxpayers

Chart 19: Comparison of benefits from Saskatchewan tax reform alternatives for single taxpayers at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.



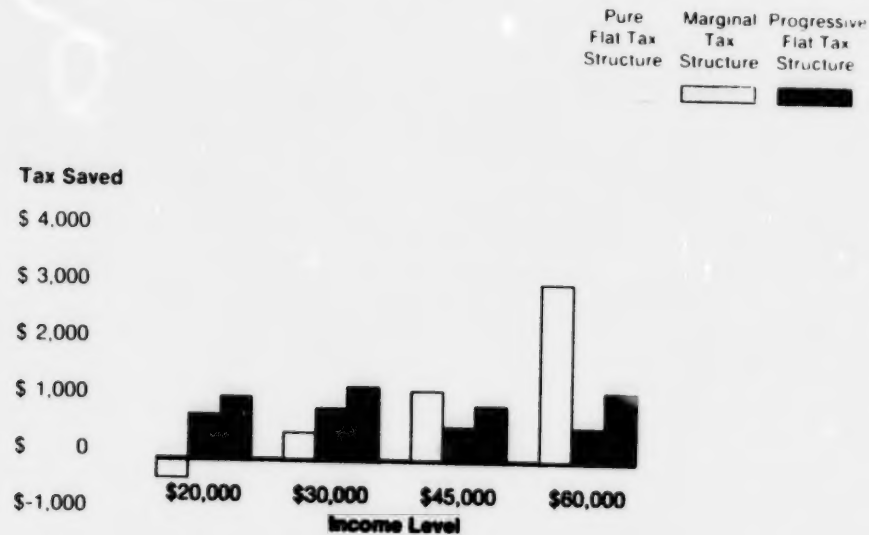
### Savings for Single Taxpayers

Chart 20: Comparison of benefits from Saskatchewan tax reform alternatives for single taxpayers. Tax savings are shown in dollars and include the effects of federal tax reform.



### Percentage Savings for Married Taxpayers

Chart 21: Comparison of benefits from Saskatchewan tax reform alternatives for single-income families, with two children, at selected income levels. Tax savings are shown as a percentage of pre-reform taxes and include the effects of federal tax reform.



### Savings for Married Taxpayers

Chart 22: Comparison of benefits from Saskatchewan tax reform alternatives for single-income families, with two children, at selected income levels. Tax savings are shown in dollars and include the effect of federal tax reform.

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## Conclusion

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Tax reform was initiated by Saskatchewan in 1985 because of the pressing need to return to a tax system that raised revenue in a fair and simple manner. The Saskatchewan Flat Tax was an important first step. Federal tax reform takes another step forward by removing inequities in the tax base and lowering tax rates.

These initiatives serve to improve the tax system by making it more neutral in its treatment of income, while continuing to support the progressive application of income tax.

Further action is needed to reform our provincial income tax system so that it meets the basic principles of fairness, support for the family, simplicity, economic development and harmony.

The alternatives presented in this paper are intended to generate discussion and debate. We welcome the comments of the people of Saskatchewan along with their suggestions about the future shape and direction of tax reform.

Over the next few months, we will be meeting with the federal government to canvass its views on the alternatives presented in this paper. It is our hope that provincial interests can be furthered within the tax collection agreements. We will also be circulating this paper to other provinces for discussion.

After adequate discussion, it is the Government of Saskatchewan's intent to present a proposal for the reform of Saskatchewan's 1989 personal income tax system.

Saskatchewan will take decisive action to design its tax system so that it is a positive force in shaping our social and economic future.

Each of us has a vision of what the future of Saskatchewan should be. Each of us also knows that the tax system is intimately related to that future. This paper is the next step in articulating that vision and shaping that future. This is the real challenge of tax reform.